October 2, 2003

Mary Cottrell, Secretary
Department of Telecommunications and Energy
One South Station, 2nd Floor
Boston, MA 02110

RE: KeySpan Energy Delivery, D.T.E.03-85

Dear Secretary Cottrell:

On August 25, 2003 KeySpan Energy Delivery New England ("KeySpan" or the "Companies," referring to Boston, Colonial and Essex Gas subsidiaries) filed a letter with the Department of Telecommunications and Energy (the "Department") requesting authorization to change its gas purchasing practices. KeySpan claims that the new gas purchasing practices would temper price volatility for the customers of the Companies. On September 18, 2003, the Department issued a Notice of Inquiry that set October 2, 2003, as the deadline for submitting comments on the Company's filing.

While the Attorney General believes that many customers would prefer less price volatility, KeySpan has not supported its method with testimony, schedules or analysis. The Companies failed to satisfy their burden to prove that they have submitted an appropriate program to achieve this goal under the Department decision in *Risk Management to Mitigate Natural Gas Price Volatility*, D.T.E. 01-100 (2002). The Department should fully investigate the Company's suggested purchasing practices before allowing changes.

The Department has recently recognized that competitive options do not exist for small customers and has expressed its willingness to review proposals to mitigate commodity price volatility. *Bay State Gas Company*, D.T.E. 01-81, p. 27 (2002). The Department should fully investigate KeySpan's suggested purchasing practices in the context of a generic investigation into the gas purchasing practices for all Massachusetts Local Distribution Companies ("LDCs"), and the outlook for retail residential competition.[1] A generic investigation would provide a platform to more fully explore common issues, including price signal issues.

<u>KeySpan's Proposal</u>

KeySpan's proposed changes would allow the Companies to lock in prices for up to two-thirds of the normal gas requirements for the 2004/05 winter. If the Department approves the proposal for effect November 1, 2003, the Companies allege they would purchase 1/12 of their normal non-storage winter requirement in each of the next 12 months. Specifically, the Companies state:

> The prices charged to customers through the Cost of Gas Adjustment clause in the peak period 2004-05 for the portion of gas purchased using this approach would equal the average price obtained by the Company for these supplies over the twelve-month purchasing period. This approach would serve to limit the price volatility that can occur in the natural gas marketplace, especially when that volatility occurs in the winter months and coincides with cold weather and increase consumption by customers.

KeySpan Letter Filing, August 25, 2003, p. 2.[2]

The Companies currently purchase gas supplies based on either first-of-month or daily market prices. These indexed prices can be volatile, as they fluctuate with monthly market conditions. By purchasing and storing approximately one-third of their normal winter requirements during the off peak period, the Companies mitigate the winter volatility. The storage purchases are made in equal amounts during each of the seven months of the off peak period. According to the Companies, this provides a level of cost stabilization that mitigates winter price volatility and the implementation of the proposal would further stabilize customers' gas costs. *Id.*

<u>Department Standards</u>

During the past several years, as the Department has supported the development of the competitive retail natural gas market, natural gas customers have been subjected to significant price volatility without any relief being offered by the competitive market. In *Risk Management*

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[1]The Attorney General has made similar requests in *Forecast and Supply Plan, 2002-2007*, D.T.E. 02-75 (pending) and *KeySpan*, D.T.E. 03-40 (weather stabilization pending) for the Department to open a generic investigation to develop a comprehensive plan for retail natural gas competition in Massachusetts.

[2] The Companies claim that their proposal is consistent with the Department guidance as provided in its DTE 01-100 order addressing "the appropriateness of using risk management techniques to mitigate natural gas price volatility."

to Mitigate Natural Gas Price Volatility, D.T.E. 01-100 (2002), the Department opened an investigation into "the appropriateness of using risk management techniques to mitigate natural gas price volatility" in 2001. In its October 2002 order, the Department determined that:

(1) price risk management programs are unlikely to produce prices below index prices on average over time (D.T.E. 01-100 at 6);
(2) financial hedging programs are costly (D.T.E. 01-100 at 15);
(3) the Department would not require the implementation of risk management techniques to address price volatility--companies could propose hedging programs individually and the Department would assess each proposal (D.T.E. 01-100 at 8);
(4) financial risk management programs are not necessarily adverse to the implementation of customer choice programs (D.T.E. 01-100 at 16); and
(5) the use of incentives in a gas price hedging program could be detrimental to the development of customer choice and would not be consistent with the Department's promotion of market-based regulation (D.T.E. 01-100 at 24).

The Department also directed that any utility proposal must:

(1) allow customers to volunteer to participate in the plan;
(2) maintain the objective of volatility mitigation and price stability rather than the objective of procuring prices below indices;
(3) ensure fair competition in the gas supply market;
(4) allocate all costs to program participants only;
(5) demonstrate the effect that the plan would have on the reliability and transparency of commodity price; and
(6) contain no incentives.

D.T.E. 01-100 at 28.

<u>KeySpan's Proposal Does Not Satisfy Department Standards.</u>

This is the first proposal submitted by an LDC in response to the Department's directives in D.T.E. 01-100. It purports to address price volatility, a concern for all of Massachusetts LDC sales customers, raising issues common to all LDCs and their customers. KeySpan's two page letter with its sketchy description of the proposal in this case, however, does not meet the basic evidentiary requirements needed to support any analysis or approval. There is no testimony, exhibits or details of how the plan would be implemented. The Companies' proposal lacks sufficient detail necessary to determine whether it provides any measurable benefit to customers. It is also unclear from the filing whether the Companies are seeking authority to "implement a change in their purchasing practices" as a pilot program that would affect only the 2004-05 winter CGA, or whether they are seeking permanent authority. It is impossible to determine whether any of the Department's other criteria from D.T.E. 01-100 have been met. Participation is not voluntary, as required by the Department.[3] The Company clearly does not intend to isolate the costs of this new program and allocate those costs only to those who wish to participate. This lack of information results in at least the following deficiencies:

(1) no analysis of costs and benefits over time;
(2) no discussion of how the Companies would administer the program;
(3) no specification of which purchasing practices would be modified and how the practices would change;
(4) no details as to what degree, if any, financial derivatives would be used;[4]
(5) no explanation of how the Companies' capacity management agreement affects the proposed program;
(6) no discussion of how the proposal relates to other KeySpan hedging programs;
(7) no indication of how the program is consistent with the development of a competitive market in Massachusetts; and
(8) no plan as to how the Companies would address any potential gaming by customers and competitive suppliers that may find it advantageous to switch back and forth between CGA service and competitive supply.

Based on the cursory information submitted by KeySpan, the Department should not approve the

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[3] EnergyNorth, the KeySpan affiliate that provides service in New Hampshire, offers an optional fixed price commodity service. A Company witness testified how that program operated in the pending Boston Gas Company rate case. DTE 03-40, Tr. 24, at 3241-3246.

[4] The Companies do not make clear whether they propose to fix the price by actually purchasing the commodity or do so through derivative contracts. If the Companies are planning to rely on derivatives to any degree in the implementation of their gas price volatility mitigation proposal, there are other important issues that the Department should require the Companies to address during an adjudicatory proceeding. These issues include, but are not limited to:

(1) the methodology that KeySpan would use to "lock-in" the price of up to two-thirds of its winter requirements, whether through purchases of the physical gas commodity, derivatives trading, provisions in its existing portfolio management contract, or some other third party contract;

(2) the policies and procedures that KeySpan has in place (if any) to safeguard the Company and its customers from the risks associated with unauthorized commodities and derivatives trading that might result from the proposed change in purchasing practices; and

(3) the policies and procedures that KeySpan will have in place to ensure that the effects of the new purchasing practices will be isolated from KeySpan's other regulated and unregulated operations, which have shareholder incentives to profit from the trading of commodities and derivatives.

plan as filed.

<u>The Department Should Open a Generic Investigation Into Gas Purchasing Practices And Develop a Comprehensive Plan For Retail Natural Gas Competition In Massachusetts.</u>

The Department should address these issues generically by opening an investigation into gas purchasing practices for all LDCs, applying hedging techniques to Cost of Gas Adjustment ("CGA") gas purchases, other price volatility mitigation measures in general, and the outlook for retail residential competition. As an alternative, the Department could conduct a full investigation into the KeySpan proposal, opening the proceeding to all interested parties and providing a schedule for discovery, hearings including cross examination of witnesses to develop a complete record, and briefs. If the latter course is taken, the Department should require that the Company provide testimony of expert witnesses that supports a detailed proposal, including the specific mechanics, parameters and guidelines that the Companies intend to implement. The testimony should be supported by exhibits that at a minimum should include evidence of the anticipated costs and benefits of the proposal.

The Attorney General is concerned about price volatility and would support a plan that addresses customers' needs, consistent with the goals of least cost procurement and reliability. During these unsettled times in the energy markets, however, the Department should not rush into accepting a proposal that has not been fully articulated and crafted to provide clear benefits to customers. For all of the above reasons, the Department should fully investigate the Companies' proposed change in purchasing practices, open a generic investigation into gas purchasing practices and develop a comprehensive plan for retail natural gas competition in Massachusetts.

Sincerely,

Alexander J. Cochis
Assistant Attorney General
Utilities Division

cc: Service list